POLICY AND REGULATORY STEWARDSHIP

Tax policy report: **High-Wealth Individuals Research Project: April 2022 update**

Date:	6 April 2021	**Priority:**	Medium
Security level:	In Confidence	**Report number:**	IR2022/125

Action sought

	Action sought	Deadline
Minister of Revenue	**Note** the contents of this report **Refer** to the Minister of Finance for their information	NA

Contact for telephone discussion (if required)

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6 April 2022

Minister of Revenue

High-Wealth Individuals Research Project: April 2022 update

Executive Summary

1. This report provides you with an update on various aspects of the High-Wealth Individuals Research Project.

Collection of information

2. The family details questionnaire achieved a high response rate, giving us confidence that we had successfully contacted most of the individuals in the initial population. In February, the entity collection was sent to HWIs and their partners. The purpose of this collection is to identify all non-portfolio entities (and trusts) linked to the family unit. The questionnaire was due to be returned by 4 April 2022. At the date of this report, we have received around 360 responses with around 100 people having sought extensions.

3. The financial collection is planned for June 2022. This collection will ask questions on portfolio investments, trusts, real property, and realised capital gains.

Methodology

4. The Project will use the following three income measures to calculate effective tax rates (ETRs): taxable income, gross cash income, and economic income. Foreign income will be included to the extent it is taxable in New Zealand. Capital gains will be included within the gross cash income (realised gains) and economic income measures (realised and accrued gains).

5. One principle we will follow in calculating ETRs is symmetry between the income definition and taxes included. This means that for gross cash income we will include the share of corporate or trustee tax relating to realisation events. For economic income, we will include the tax entities paid in proportion to the families holding of those entities. Some taxes will be excluded from our analysis on materiality grounds or because they are difficult to collect information on.

6. We intend to estimate GST paid based on HWI's estimated consumption. We do not have direct measures of consumption of the population so will need to estimate their consumption. We are considering different approaches to this.

7. Gifts and inheritances will be included in our calculation of income to the extent that these gifts and inheritances subsequently generate income. We will seek information on the value of inheritances from the individuals.

Data progress

8. Following the construction of our database, we can now provide summary statistics for the lead individuals from the HWI population on a taxable income measure. This information is already held by Inland Revenue in our database.

Purpose

9. This report updates you on progress on the High-Wealth Individuals Research Project (the Project).

10. The major milestones in the Project since the last update have been processing the family details survey responses and issuing the second information collection, the entity collection.

Collection of information

Family details and entity collections

11. The family details collection has ended. This questionnaire achieved a high response rate, giving us confidence that we had successfully contacted most of the individuals in the initial population. The information has been processed and updated into our secure database ready for the next step of the process.

12. In late February, the entity collection was sent to HWIs and their partners. The purpose of this collection is to identify all non-portfolio entities (and trusts) linked to the family unit. As with the family details collection, these requests were issued under section 17GB of the Tax Administration Act 1994 (TAA) meaning that individuals are legally required to respond.

13. In the entity collection, non-trust entities are required to be disclosed where the family unit (including through trusts) owned more than 10% of the entity in any year from 2016-2021. Each family members ownership interest (percentage ownership) is then separately reported. Both direct and indirect interests in entities are required to be disclosed. For trusts, a trust is required to be disclosed if a family member was a beneficiary, settlor or appointer of a trust with gross assets over $1 million in any year 2016-2021.

14. The questionnaire was due to be returned by 4 April 2022. Some recipients (around 100) have requested and been granted an extension of time until 29 April. At the date of this report, we have received around 360 responses (out of a total population of around 650).

15. Our initial population was 406 high-wealth family units. We have excluded around 30 family units from the collection on the following grounds: compassionate grounds, non-resident for the entire period of the study, or they provided evidence that their net wealth was well below $20 million for the entire period of the study. Where we have good internal data on individuals excluded from the collection on compassionate grounds, these people may remain in the study population. Furthermore, there were 15 people in the population who we have not been able to contact through any means. This leaves a final population of around 361 family units for the collection.

16. The financial collection is planned for June 2022. This collection will ask questions on portfolio investments, trusts, real property, and realised capital gains. For entities income and balance sheet measures, Inland Revenue generally already has this information through the IR10 statement. There are however gaps in this information for the population. For this reason, we are intending to undertake a separate targeted collection of entity financial information in late June. This will involve only asking individuals for this information when we have insufficient internal information. s 9(2)(h) [redacted]

Methodology

Update on methodology

17. We have held two meetings on the methodology with the Methodology Advisory Group (MAG) and a third will be held in April. As you will recall, the MAG is a group of 10 experts from the economic, legal, accounting and statistical fields. Three notes were prepared for the MAG, on income bases, included taxes and capital gains. Below is a summary of some key points.

Income

18. The Project will use the following three income measures to calculate effective tax rates (ETR):

    i. Taxable income = Personal taxable income as defined by New Zealand tax law (this will include taxable capital gains). This provides a comparator for the other two measures, which use an income base broader than taxable income.

    ii. Gross cash income = Personal taxable income + untaxed realised capital gains and accrued gains on portfolio investments.[1] This measure is based on how a realisation-based capital gains tax may be designed.

    iii. Economic income = Personal taxable income + untaxed realised gains + accrued capital gains.

19. Economic income will also include a secondary measure that includes imputed rental income from owner-occupied housing. This is a measure of the value one obtains from living in their own home, as opposed to renting it out.

20. Foreign income will be included to the extent it is taxable in New Zealand.[2]

Calculation of capital gains

21. Capital gains will be included within the gross cash income (generally, realised gains) and economic income measures (realised and accrued gains).

22. While any assets could potentially give rise to capital gains, we are limiting our focus to the asset types most likely to give rise to material and measurable gains. The assets that we will calculate capital gains for are:

    - real property (residential and non-residential),
    - businesses (companies, partnerships, and trusts), and
    - financial (portfolio) assets.

23. Capital gains will be calculated for the period of the study (2016 – 2021). Accrued gains (for economic income) will be calculated for every year of 2016-2021, either based on modelled annual values or listed prices. As New Zealand does not have a capital gains tax, the calculation of realised gains for assets without a listed price requires the establishment of a 'cost base'. We intend to use 1 April 2016 (or the 2016 balance date) as the valuation date for the cost

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[1] This measure is largely based on realised gains, however, to reduce compliance costs income from portfolio investment will be calculated as an aggregate of Closing balance less Opening balance (less contributions, plus capital pay outs).

[2] This avoids many of the problems of whether and how to include foreign taxes in the tax measure, including how to source that information. It also avoids questions of how to treat gains and losses from currency movements, which in some cases may dominate other gains. For income taxable in New Zealand, foreign tax credits will be recognised.

base. As reported to you previously, 2016 has been chosen as the first year of the study as this is consistent with the period for which individuals need to retain records. We therefore expect individuals will be able to provide the information to calculate gains based on a 2016 valuation date.

24. For gross cash income, the realised gains (and the associated tax) will be fully attributed to the year of sale. However, for economic income the realised gain will be spread over the years (2016 - sale date) to estimate an annual gain.

25. The gross cash income and economic income measures will include the income from entities the family unit have an interest in (including trusts)[3]. The income will be calculated as the capital gain that arises from the entity plus distributions from the entity. Capital gains from unlisted non-portfolio entities will be calculated by estimating an annual value of the entity based on its earnings before tax, interest, and depreciation. However, where an entity is 'land rich', it will be valued as if it were real property.[4]

Taxes included

26. One principle we will follow in calculating ETRs is symmetry between the income and taxes included - including any taxation attributable to an included income flow. This ensures the 'income' and 'tax' base in the calculation are consistent.

27. This means that for gross cash income we will include the share of corporate or trustee tax relating to realisation events (e.g., sale of shares). For economic income, we will include the tax entities paid in proportion to the family's holding of those entities.

28. Some taxes will be excluded from our analysis on materiality grounds (such as fringe benefit tax, excise tax, gaming duties) or because they are difficult to collect information on (for example, the ACC levy). Local body rates will not be included as our focus is on central government.

29. ETR measures will be calculated both including an estimate of GST paid by the individuals and excluding this estimate. We intend to estimate GST paid based on HWI's estimated consumption. We do not have direct measures of consumption of the population so will need to estimate their consumption. We are considering different approaches to this.

30. Tax paid will be measured on a cash basis (i.e., in the year it is paid) because this is the most certain approach and consistent with academic literature.

31. The following table sets out what is included in each measure:

Tax and Income Included Under Each Income Measure		
Taxable Income	Gross Cash Income	Economic Income
Income as defined under the Income Tax Act	Taxable income plus realised capital gains	Taxable income plus realised and accrued capital gains
• Personal income tax • Imputation credits used recognised as tax paid	• Personal income tax • Imputation credits used recognised as tax paid • Proportion of change in the entity's imputation credit	• Personal income tax • Company tax • Trustee tax

[3] The method to allocate the income and taxes of trusts to individuals is yet to be finalised as a trust's relationship to individuals is more complicated than that of other entities.
[4] A land rich entity will be one for which real property is more than 80% of its assets.

	account relating in a realisation • Attribution of trustee tax on trust distributions	
	Addition of GST	

Gifts and inheritance

32. We do not intend to collect information about registered charities individuals are associated with. This is because there is limited scope for individuals to personally benefit from their association with charities and allocating charities' assets and income to individuals may give a misleading impression.

33. When individuals receive tax credits for donations that amount will not be deducted from tax paid. We see such credits as more akin to government expenditure than taxation.

34. One matter to consider is whether information should be sought on inheritances. Inheritances will be included in our calculation of income to the extent that the inheritance subsequently generates income. For example, if an individual inherits shares the income from those shares will be included in our income measure. For this reason, there is an argument not to collect information specifically on inheritances, as we will already be capturing information on the value of any inherited assets. However, collecting this information may provide insight into how wealth is accumulated. If information on inheritances were to be collected it could either be collected:

    i. For the period 2016-2021 consistent with the period of the study. However, this is likely of limited value given an individual may have inherited assets outside the period of the study that contribute to their income.

    ii. For their lifetime. This would provide further insight into wealth accumulation but raises the issue of inflation adjustment as some individuals may have inherited several decades ago. We propose to collect information on the nominal value of inheritance received for each decade of the individual's life, estimated to the nearest million.

35. We do not intend to ask individuals what gifts they have received or include gifts received[5] within our measures of income. In effect we have chosen to treat gifts as an asset transfer rather than income. If gifts were included in our measures, it may create an imbalance as the gift giver is not necessarily included in our population (and if a gift is income to the receiver, it should be treated as a deduction to the giver). However, income subsequently generated from gifts will be included as income, similar to inheritances.

[5] Gifts are anything given by one party to another, without consideration being exchanged. This does not include distributions from a trust. Gifts may take the form of goods, services provided or cash and may be periodic or one offs. Previous literature has been divided on whether gifts should be treated as income or asset transfers in income distribution models. We have chosen to treat them as assets transfers. Not including gifts within our income measure means we do not have to ask potentially intrusive questions about gifts given and received, and we avoid the complexities of trying to value non-cash gifts.

Analysing information

Data progress – Taxable Income example

36. Following the construction of our secure database, we can now provide summary statistics for the lead individuals from the population on a taxable income measure. This information is already held by Inland Revenue.

37. Both taxable income and the ETR have been calculated using fields from the Individual Income Tax return (IR3). We still need to adjust for individuals who did not need to file an IR3 for a specific year, had negative taxable income, and include Portfolio Investment Entity (PIE) income and tax.

38. The summary statistics below include income received directly by the individual from: income with tax deducted, interest and dividends, Trust and Estate, Partnerships, overseas, property. See the appendix for further details on income types included.

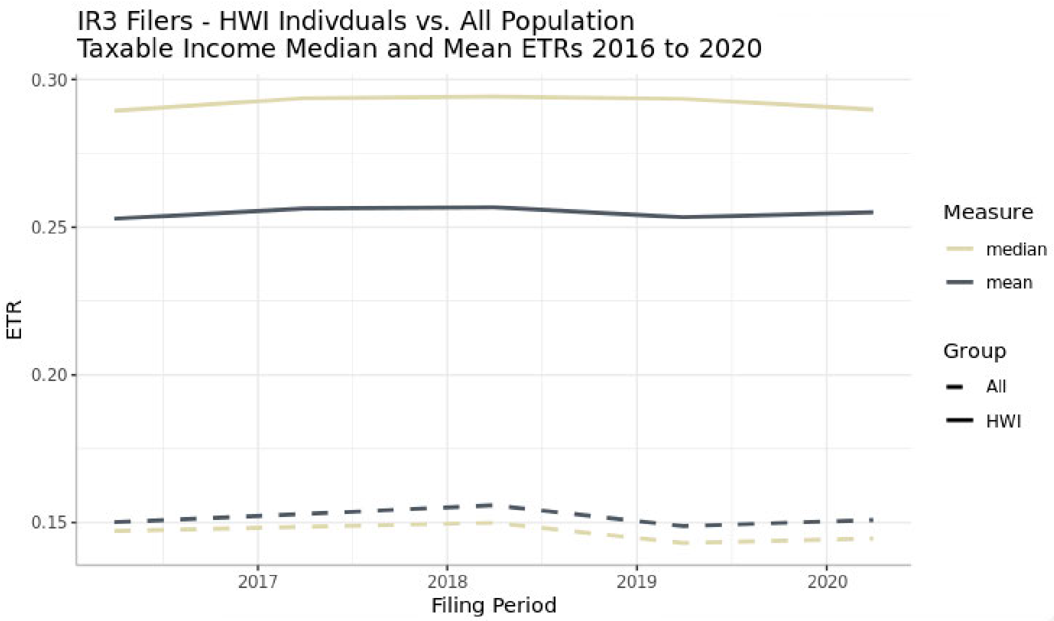
39. We have calculated the ETR by taking the tax calculated on the above sources dividing by the above-mentioned taxable income. The analysis demonstrates current tax rates for individuals, that being the progressive marginal tax scale. The purpose of the taxable income ETR is to provide a comparator to the broader ETR measures we will calculate.

40. Table 1 and the graph below show summary statistics for the HWI population who filed an IR3 compared with all IR3s filed for the 2016 – 2020 tax years.

Table 1. Summary Statistics for HWI lead individuals IR3s vs. All IR3 Filers

HWIs	1st Quartile	Median	Mean	3rd Quartile
Taxable Income	88,114	238,347	747,128	588,256
ETR	0.23	0.29	0.25	0.31

All Poplulation	1st Quartile	Median	Mean	3rd Quartile
Taxable Income	16,057	34,646	46,437	60,585
ETR	0.11	0.15	0.15	0.18



41. These figures may differ from those in the upcoming Treasury analytical note which is based on assumptions and scenarios rather than Inland Revenue data.

Next steps

42. We plan to report to you in July 2022 to provide an update on the financial collection and database construction.

Recommended action

We recommend that you:

agree to proactively release this report.

Agreed/Not agreed

refer a copy of this report to the Minister of Finance for their information.

Referred/Not referred

s 9(2)(a)

Felicity Barker
Project Director, Wealth Research Project
Policy and Regulatory Stewardship

Hon David Parker
Minister of Revenue
/ /2022

Appendix 1

<table>
<tr><th>IR3 Income type</th><th>Description (if required)</th></tr>
<tr><td>Income with tax deducted</td><td>▪ Salary and Wages
▪ Income tested benefit
▪ Student Allowance
▪ New Zealand Superannuation
▪ Accident compensation payments related to earnings
▪ Other pensions, annuities, or superannuation
▪ Shareholder-employee salary with PAYE deducted</td></tr>
<tr><td>Schedular payments</td><td></td></tr>
<tr><td>New Zealand interest</td><td></td></tr>
<tr><td>New Zealand dividends</td><td></td></tr>
<tr><td>Māori Authority distributions</td><td></td></tr>
<tr><td>New Zealand Estate or Trust income</td><td></td></tr>
<tr><td>Overseas income</td><td></td></tr>
<tr><td>Partnership income</td><td></td></tr>
<tr><td>Look-through company income</td><td></td></tr>
<tr><td>Shareholder-employee salary with no PAYE deducted</td><td></td></tr>
<tr><td>Income or expenditure from residential property</td><td>Income and deductions subject to the residential property rules</td></tr>
<tr><td>Other rents</td><td>▪ Bach or holiday home
▪ Family home
▪ Rental properties held on revenue account
▪ Commercial rents</td></tr>
<tr><td>Self-employment income</td><td></td></tr>
<tr><td>Income from taxable property sales/disposals</td><td>▪ Income from land sales that are excluded from the residential property deduction
▪ Rules including taxable sales of the main home or holiday homes taxed under the mixed-use asset rules
▪ Tax losses from disposals of residential property</td></tr>
<tr><td>Government subsidy</td><td>▪ For the 2021 tax year onwards
▪ Total Covid-19 wage subsidy, wage subsidy extension, wage subsidy resurgence and wage subsidy received by an individual where tax was not deducted at source and passed on to Inland Revenue</td></tr>
<tr><td>Other income</td><td>▪ Sale of non-FIF shares or other property
▪ Financial arrangements
▪ Cash jobs, payments made 'under the table', tips, bartering or income from an illegal enterprise
▪ Any share of partnership income as a result of capital investment
▪ Free or discounted shares received under an employee share scheme if the employer has not provided information
▪ Amount of loss carry-back to 2019</td></tr>
<tr><td>Other expenses</td><td></td></tr>
<tr><td>Net losses claimed this year</td><td></td></tr>
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